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A light at the end of the tunnel?

Self-sufficiency with cashflow-driven investment for UK Defined Benefit pension schemes

KPMG Investment Advisory

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Self-sufficiency: Light at the end of the tunnel?

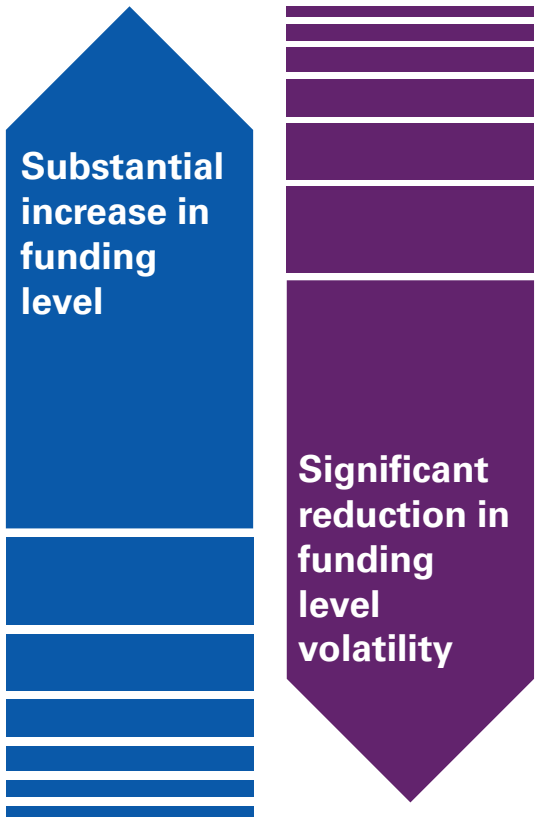
Despite a recent improvement in funding levels, trustees and sponsors would be forgiven for thinking that they are still a long way from low-risk long-term targets such as self-sufficiency.

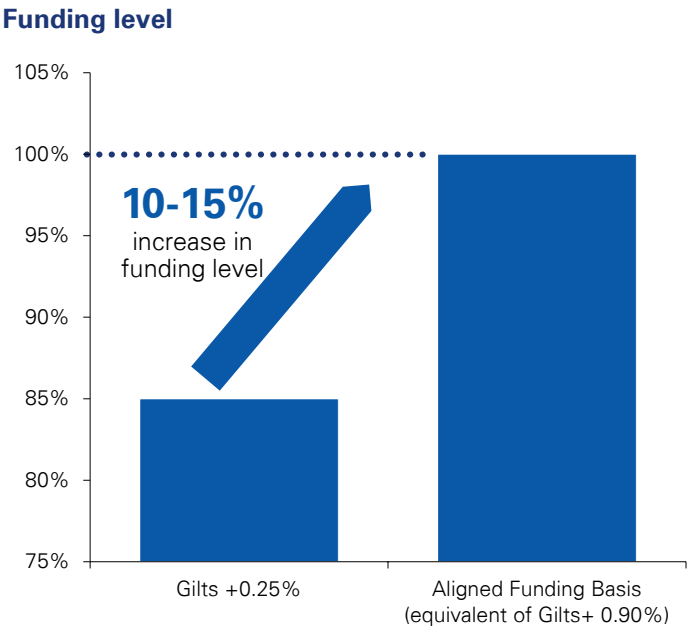
We have challenged a number of the commonly accepted definitions of self-sufficiency and concluded that through the smart integration of funding and a cashflow driven investment (CDI) strategy, many schemes could be much closer than they think.

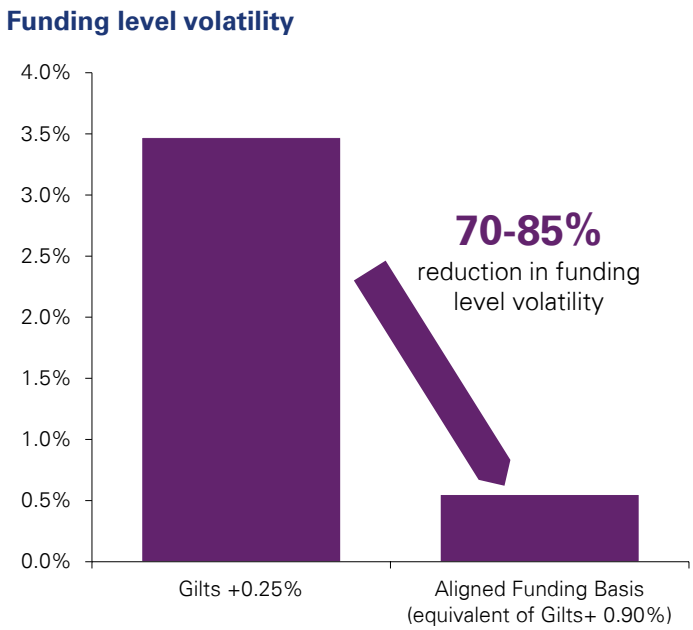
Historically, self-sufficiency targets have been based on a 'gilts- flat' discount rate (i.e. gilts +0%) or gilts plus a small margin (e.g. gilts +0.25%), with many schemes not being well funded enough to cut their reliance on higher yielding non-gilt investments in the short to medium term.

Through CDI strategies, we have helped our clients achieve the equivalent of self-sufficiency positions with a discount rate of around gilts +0.9%, which is in keeping with a fairly average strength funding basis.

Furthermore, a CDI strategy enables a much closer alignment of funding assumptions than can be achieved with traditional low-risk strategies. We have therefore helped our clients to significantly reduce their short-term financial risks, providing a stable evolution of their funding position.







Note: Asset-Liability Modelling analysis on a typical scheme targeting an expected return of Gilts+1.2% through Liability Driven Investment (full liability hedge on interest rates and inflation) and long-dated corporate bonds.

Source: KPMG Calculations, Moody's Analytics Economic Scenario Generator

Re-thinking self-sufficiency

The term **self-sufficiency** is not uniquely defined and can be used to mean a range of things to different pension scheme trustees, sponsors and their advisors.

The general principal however is that a self-sufficient scheme has a **reasonable expectation that it will not need to call on the sponsor for additional funding**.

Do we have it all backwards?

The fundamental pension scheme purpose is to use its assets to meet benefit payments. If you can always pay benefits without recourse to the sponsor, you are (by common sense definitions) self-sufficient.

However, traditional self-sufficiency strategies have focused on minimising short-term volatility measures such as "Value at Risk". While these risk measures are important, they are not the best lens for assessing the ability of a scheme to make long-term payments, and therefore not enormously helpful in judging the reliance on the sponsor.

A much more sensible approach is to focus on the scheme's ability to meet its long-term cashflows first, and to worry about the short-term volatility second.

The long-term: Meeting cashflows with investment

A CDI strategy is designed to maximise the probability of meeting benefit payments by investing in assets which provide known cashflows.

In fact, a well-designed CDI strategy can achieve the same (or even higher) probability of meeting long-term cashflows while also targeting a significantly higher return to help control sponsor contributions.

On a traditional funding basis, this may increase short-term 'mark-to-market' risks somewhat, however we show that this can be more than offset by aligning the funding basis to the investment strategy.

CDI therefore presents a powerful case for adopting a more realistic self-sufficiency basis. This is directly linked to the investment strategy by allowing the yield delivered by the portfolio to play a full part in driving the liability calculations.

The short-term: Stabilising volatility with funding

If your investment strategy ultimately gives you more security over the long-term, this shouldn't come at the sacrifice of increased volatility in the short-term.

The funding strategy for any scheme should be aligned to the investment strategy. A CDI strategy enables a closer link to the funding basis, which provides a much smoother funding level progression.

Most importantly, this type of funding strategy can also be set to reflect the underlying covenant strength of the sponsoring employer and to build in sufficient prudence to cover any unanticipated developments.

This approach is fully aligned with the Pensions Regulator's integrated risk management guidance, providing a tangible link between covenant, investment strategy and funding.

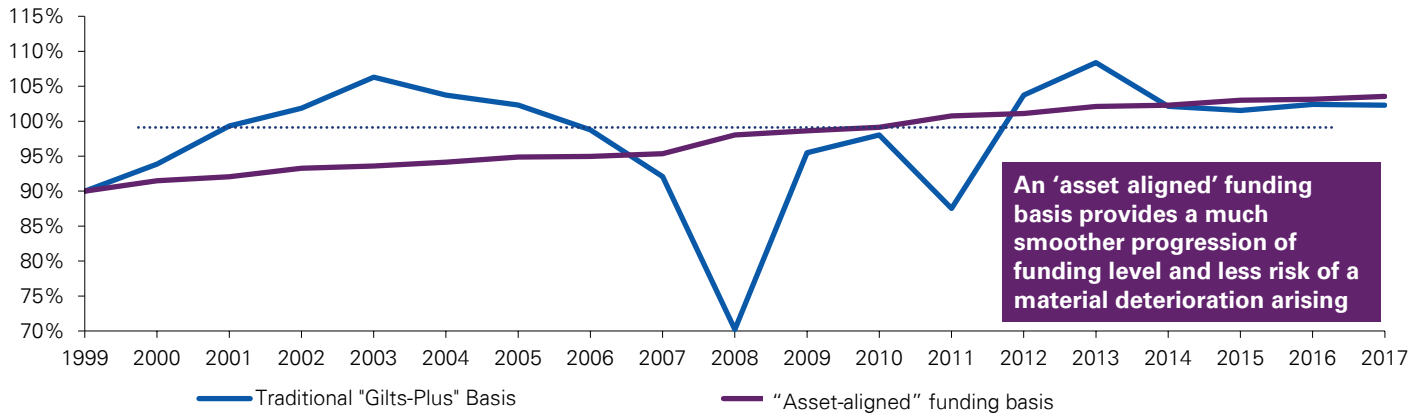
Comparison of investment strategies: Forward looking asset-liability modelling	**Traditional self-sufficiency investment strategy[1]**	**CDI strategy[2]**
Scheme asset value	*£77m*	*£69m*
Three year value-at-risk (measured on a traditional 'gilts-plus' basis)	£2.4m	£6.2m
Three year value at risk (measured on an 'asset-aligned' basis)	**n/a**	**£1.4m**
Probability of meeting ultimate cashflows	***90%***	***90%***

Note: Asset-Liability Modelling analysis on a simplified liability profile consisting of a single liability payment of £100m in 15 years' time.

[1] Assumes scheme is fully funded on a Gilts+ 0.25% basis with investment expected return of Gilts+ 0.6%

[2] Assumes scheme is fully funded on a Gilts+0.9% basis with investment expected return of Gilts+ 1.2%

Funding level of a CDI strategy: Historical back-test



Note: Chart shows historical funding level progression for a typical scheme with a Cashflow Driven Investment strategy, where liabilities are measured on two different liability basis.

Source: KPMG Calculations, Thomson Reuters Eikon

Seize the opportunity!

Three reasons why long-term targets should be firmly back on the agenda

Improved funding levels:

Schemes have seen a welcome improvement in funding levels over recent years on the back of:

a. strong equity returns and

b. increased use of liability hedging investment strategies.

This has put self-sufficiency back in sight for many schemes, particularly when using an "asset-aligned" funding basis.

The return of volatility:

Strong equity returns have also brought about high valuations and the return of volatility following a sustained period of stability.

Through the adoption of our approach, schemes no longer need to run the gauntlet of investment risk. A CDI strategy alongside an "asset-aligned" funding basis can enable schemes to achieve a more secure self-sufficiency position.

Government White Paper:

With almost coincidental timing, the UK government recently issued their White Paper entitled "Protecting defined benefit pension schemes" in which they detail the potential requirement for schemes to set long-term funding objectives such as self-sufficiency or buy-out.

An approach which can be right for both Trustees and Sponsors

A good approach to setting long-term objectives requires the integration of investment strategy, funding and covenant. Our approach provides a tangible link between these key factors along with a number of significant potential benefits to both the Trustees and the Sponsor.

Significant risk reduction at earlier opportunity

Achieved for little or no additional cost

Reduced deficit volatility

Stability in contribution requirements

Reduced ongoing reliance on sponsor

Overfunding less likely

Liquidity risks managed effectively

KPMG has already helped to implement this innovative approach with a number of clients and our experience has taught us that the following factors are critical to successful implementation:

— Deep expertise across both funding, investment and covenant

— Collaborative working between Sponsor and Trustee

— An advisor who can build strong relationships with all stakeholders to understand their specific objectives and provide innovative solutions.

KPMG is strongly placed to help clients across each of these areas, and we would be delighted to discuss the potential benefits to your scheme in more detail.

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